Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of:	)	
Review of the Commission's Rules Regarding the Pricing of Unbundled Network Elements and the Resale of Service by Incumbent Local Exchange Carriers	)	WC Docket No. 03-173

COMMENTS OF THE COMPTEL/ASCENT ALLIANCE AND THE PACE COALITION

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SUMMARY

The CompTel/ASCENT Alliance ("CompTel") and the PACE (Promoting Active Competition Everywhere) Coalition support the Act's goals and the FCC's stated objectives for initiating the Notice of Proposed Rulemaking ("NPRM") in this proceeding. However, many of the FCC's tentative conclusions about potential modifications to its TELRIC-based UNE pricing methodology would inhibit competition rather than achieve the primary goal of the Telecommunications Act of 1996 (the "Act") or the FCC's stated objective of fostering competition. CompTel and the PACE Coalition urge the FCC to retain its existing TELRIC methodology with its long-run focus for establishing UNE prices.

TELRIC-based pricing provides appropriate compensation that encourages economic efficiency and that values ILEC investments in the same manner as they would be valued in a fully competitive market. Importantly, the TELRIC model makes no assumptions about whether the market is actually competitive or not, because the level of competition in the marketplace does not affect the price calculation. Rather, TELRIC is designed to replicate competitive conditions regardless of whether those competitive conditions otherwise exist at this time. As such, there is no need to adjust TELRIC or reexamine its appropriateness in light of an increase in competition in the relevant telecommunications market. Thus, the NPRM is flawed to the extent it is based on the assumption that the development of competition can affect whether TELRIC continues to be the appropriate UNE pricing mechanism.

In any event, nothing has changed since the Supreme Court affirmed the current TELRIC-based pricing rules, and thus the FCC should retain its current rules because they continue to be economically correct and legally sound. Unnecessary reexamination of the

TELRIC pricing standard from the ground up, not to mention the modifications that the FCC has tentatively proposed, creates regulatory uncertainty and imposes additional costs both on the states that will have to implement the modifications ultimately adopted by the Commission and the carriers that will have to participate in the related proceedings.

The NPRM appears to be based on the false assumption that increasing UNE rates will increase the incentives for investment by both the ILECs and competitive carriers. However, there is no evidence that the current TELRIC-based rates have chilled investment by the ILECs or competitive carriers, or that they have not allowed the ILECs to recover their costs. If the FCC nonetheless decides to depart from TELRIC in any way, the agency must ensure that the pricing methodology is fully consistent with well-established economic principles – whether TELRIC or a short run pricing methodology – rather than a mix of various methodologies that is designed to achieve a specific predetermined result. Manipulating the TELRIC pricing mechanism in ways that are inconsistent with core economic principles in order to achieve artificial UNE prices would be fundamentally inconsistent with the 1996 Act because it would create entry barriers and inhibit competition rather than lower entry barriers and facilitate new entry.

The attached Declaration of Economist Joseph Gillan explains that the one circumstance under which the FCC might consider applying a short-run approach in place of TELRIC is where the Triennial Review Order ("TRO") requires ILECs to provide requesting carriers with access to legacy network facilities but not to new network facilities that the ILEC can install to replace the legacy facilities. Under these conditions, the TRO imposes a short-run horizon on CLEC access: The ILEC will not make any additional investments in its legacy network no matter what decisions CLECs make with respect to that network. As such, it might be appropriate to price

access to the legacy network facilities based upon a short-run economic pricing methodology that will more accurately reflect the cost that the ILEC incurs with respect to the legacy network facilities (*e.g.*, the cost of maintenance). However, if the FCC elects to apply a short-run pricing methodology under these circumstances, it must apply a short run model that is fully consistent with core economic principles, which most likely will result in prices that are lower than today's TELRIC-based prices.

Regardless whether the FCC retains TELRIC pricing (or applies a short-run economic pricing methodology for UNEs that ILECs can replace with network facilities which are not subject to unbundling), where the TRO requires ILECs to provide only "partial" access to a network element (*e.g.*, a 64kb channel on a broadband facility), the pricing for that particular network element should be allocated between the UNE and non-UNE applications in proportion to the relative bandwidth of each application. This will prevent ILECs from requiring requesting carriers to fund network facilities to which they have no access and cannot use.

With respect to the structure of UNE pricing, CompTel and the PACE Coalition support the recovery of switching costs solely through flat-rated charges, and maintain that flat-rate pricing would comply with the statutory pricing standard under section 252(d)(1). Switching costs do not vary by minutes of use ("MOU"), and thus flat-rate pricing for switching would be appropriate. CompTel and the PACE Coalition also generally support the recovery of most, if not all, non-recurring costs through recurring charges. By limiting NRCs to the recovery of costs that exclusively benefit the requesting carrier ordering the UNE, the FCC can reduce entry barriers while allowing ILECs to recover the cost of all activities related to the initiation of service by a requesting carrier.

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COMMENTS OF THE
COMPTEL/ASCENT ALLIANCE
AND THE
PACE COALITION

The CompTel/ASCENT Alliance[1] ("CompTel") and the PACE (Promoting Active Competition Everywhere) Coalition hereby submit these comments in response to the Notice of Proposed Rulemaking ("NPRM") that the Federal Communications Commission ("FCC") adopted in the above-captioned proceeding on September 10, 2003 and released on September 15, 2003.[2]

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[1] The CompTel/ASCENT Alliance was formed in November 2003 by the merger of the two leading trade associations in the competitive telecommunications industry, the Competitive Telecommunications Association ("CompTel") and the Association of Communications Enterprises ("ASCENT"). With 400 members, the Alliance is the largest association representing facilities-based carriers, providers using unbundled network elements, global integrated communications companies, and their supplier partners. The PACE Coalition is composed of competitive local exchange carriers that provide a variety of telecommunications services to business and residential consumers throughout the country. In providing their services to residential and small business customers, PACE Coalition carriers use the combination of unbundled network elements commonly referred to as UNE-P.

[2] *Review of the Commission's Rules Regarding the Pricing of Unbundled Network Elements and the Resale of service by the Incumbent Local Exchange Carriers*, WC Docket No. 03-173, Notice of Proposed Rulemaking (rel. Sep. 15, 2003).

I INTRODUCTION

CompTel and the PACE Coalition support the Act's goals and the FCC's stated objectives. However, many of the FCC's tentative conclusions about potential modifications to its TELRIC-based UNE pricing methodology would inhibit competition rather than achieve the primary goal of the Telecommunications Act of 1996 (the "Act") or the FCC's stated objective of fostering competition. It seems particularly counterintuitive for the FCC to launch a reexamination of its TELRIC rules so soon after they were affirmed by the Supreme Court in *Verizon v. FCC* following years of litigation and the resulting regulatory uncertainty.[3] In upholding the lawfulness of the TELRIC rules, the 7-1 majority in *Verizon* agreed with the justifications the FCC gave for rejecting the policy-based arguments of the incumbent local exchange carriers ("ILECs") against TELRIC, some of which form the basis for the tentative conclusions in the NPRM.[4] Unnecessary reexamination of the TELRIC pricing standard from the ground up, not to mention the potential modifications that the FCC proposes in the NPRM, reintroduces regulatory uncertainty and imposes additional costs both on the states that will have to implement any modifications ultimately adopted by the Commission and the carriers that will have to participate in the related state proceedings.

Apart from considering how to apply the existing TELRIC rules in light of the changes to the UNE rules adopted by the FCC in the Triennial Review Order ("TRO"), there is no factual

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[3] *Verizon Communications, Inc. v. FCC*, 535 U.S. 467 (2002).

[4] *See, e.g., id.* at 502-503, 504 (rejecting ILEC arguments that "a method of calculating wholesale lease rates based on the costs of providing hypothetical, most efficient elements may simulate the competition envisioned by the Act but does not induce it" and "even if rates based on hypothetical elements could induce competition in theory, TELRIC cannot do this, because it does not provide the depreciation and risk-adjusted capital costs that the theory compels," and holding that "comparison of TELRIC with alternatives proposed by the incumbents as more reasonable are plausibly answered by the FCC's stated reasons to reject the alternatives").

basis for considering major revisions to, or the elimination of, TELRIC. The attached Declaration of Economist Joseph Gillan explains how the FCC should allocate costs to ensure that requesting carriers are not forced to pay the cost of facilities or capacity to which they have no access under the new UNE rules.

No matter what course the FCC ultimately decides to take, however, the agency must ensure that the pricing methodology is fully consistent with well-established economic principles – whether TELRIC or a short run pricing methodology – rather than a mix of various methodologies that is designed to achieve a specific predetermined result. Specifically, if the FCC decides to depart from the TELRIC standard despite the fact that nothing has changed since the Supreme Court affirmed the current TELRIC-based pricing rules,[5] the FCC should adopt a forward-looking methodology that is consistent with well-established economic principles and which ensures that requesting carriers are not required to pay for facilities and capacity to which they have no access.

II TELRIC CONTINUES TO BE AN APPROPRIATE PRICING MECHANISM FOR UNBUNDLED NETWORK ELEMENTS

The FCC initiated this proceeding in order "to consider whether our pricing methodology is working as intended and, in particular, whether it is conducive to efficient facilities investment" "now that competition has taken root in many areas of the country . . . ."[6] Regardless whether competition has taken hold throughout the country, the FCC must base any decision to amend the current TELRIC rules upon record evidence that the current UNE pricing

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5 *See Verizon Communications, Inc. v. FCC*, 535 U.S. 467 (2002).

6 NPRM, ¶3.

framework no longer promotes the goals of the 1996 Act.[7] Moreover, the Commission's decision in this proceeding, as in all proceedings, must be rational in its assumptions as well as its conclusions.[8] CompTel and the PACE Coalition respectfully submit that there is no evidence to suggest the FCC's current TELRIC pricing methodology should be reconsidered, let alone amended, or to suggest that the assumptions upon which the NPRM is based are rational.

A. Competition Is Not Deeply Rooted in Many, if Any, Local Telecommunications Markets Across the Nation

CompTel and the PACE Coalition are encouraged by the progress that competitive carriers have made in many parts of the country, but it can hardly be said that competition is deeply rooted in many areas of the country. The ILECs continue to dominate nearly all of the local telecommunications markets across the nation, as demonstrated by both the extremely high market share that these ILECs maintain. For example, the FCC's Local Telephone Competition Reports detail that the percentage of End-User Switched Access Lines grew from 1.2% in December of 1997 to 13.2% in December of 2002.[9] These reports illustrate that, despite the progress that competitive carriers have made since Congress adopted the 1996 Act, the ILECs continue to dominate the local markets with approximately 85% of the nation's end-user switched access lines.

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[7] *See, e.g., Motor Vehicle Manufacturers Association of the United States v. State Farm Mutual Automobile Insurance Company*, 463 U.S. 29, 42-43 (1983)(holding that a decision by an administrative agency to modify or rescind an existing rule or policy must be "rational, based on the consideration of the relevant factors and within the scope of the authority delegated to the agency by the statute.").

[8] *Citizens to Preserve Overton Park v. Volpe*, 401 U.S. 402, 414 (1971).

[9] *See Federal Communications Commission Local Competition Report*, Table 2.4, available at www.fcc.gov/wcb/stats (rel. 12/31/1998) (reporting data as of December 31, 1997); *Federal Communications Commission 2002 Local Competition Report*, Table 6, available at www.fcc.gov/wcb/stats (rel. 6/12/2003) (reporting data as of December 31, 2002).

B. TELRIC Would Continue To Be An Appropriate Pricing Methodology Even If Competition Were Deeply Rooted in Some Markets

The FCC asks in the NPRM whether the two objectives of the UNE pricing regime should continue to be that UNE prices (1) are "set in a manner that sends efficient entry and investment signals to all competitors," and (2) "provide incumbent LECs an opportunity to recover the forward-looking costs of providing UNEs."[10] CompTel and the PACE Coalition believe that these should remain the primary goals of the Commission's UNE pricing rules, and that TELRIC is the best means for achieving these goals, for the same reasons the Commission adopted,[11] and the Supreme Court affirmed,[12] the TELRIC pricing mechanism in the first place.

TELRIC will continue to be the best means for achieving the goals of the Act even as the level of competition increases. Specifically, TELRIC is explicitly designed to send the same investment signals to the telecommunications industry that would be sent in a fully competitive marketplace. Therefore, TELRIC, unlike historical or embedded cost pricing methodologies, is not the type of pricing methodology that becomes increasingly less appropriate as competition in the marketplace develops. Indeed, the development of competition would be evidence that TELRIC is "working as intended" and "conducive to efficient facilities investment."

As the FCC notes in the NPRM, the ILECs argue that "the TELRIC methodology is flawed due to an alleged emphasis on unrealistic efficiency assumptions. They contend that

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10 NPRM, ¶38.

11 *See, e.g., Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, 11 FCC Rcd 15499, 15813-50, ¶¶620-89 (concluding that TELRIC is the best means for achieving the goals of Act and rejecting various other pricing methodologies).

12 *See, e.g., Verizon*, 535 U.S. at 504 (holding that "comparison of TELRIC with alternatives proposed by the incumbents as more reasonable are plausibly answered by the FCC's stated reasons to reject the alternatives").

these unrealistic assumptions result in rates that are so far below an incumbent LEC's 'actual' costs that neither incumbent LECs nor competitive LECs have an incentive to invest in new facilities."[13] This argument has been thoroughly considered and repeatedly rejected by the FCC,[14] whose rational for rejecting the argument was explicitly approved by the Supreme Court.[15]

The TELRIC pricing rules are designed to permit full recovery of both the long run incremental costs of providing the leased elements plus an appropriate share of the associated joint and common costs. The cost of all of the ILECs' productive assets are included in the TELRIC cost calculation, albeit a cost based on existing prices and the best available technology, for that is the nature of forward-looking pricing. No asset or expense is exempted from compensation merely because, in theory, its current use could be considered to be "free" because it is inherited from the past.

The ILECs nonetheless complain that they may not be able to recover some of their sunk costs if production technology or input prices improve in the future. However, ***all*** carriers in the real world experience changes in the value of their investment as technology and prices change, for that is one of the consequences of a market-based economy. There is no reason why the FCC's pricing methodology should immunize the ILECs against these basic market forces.

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13 NPRM, ¶5.

14 *See Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, 11 FCC Rcd at 15848-50, ¶¶ 683-689.

15 *See, e.g., Verizon*, 535 U.S. at 501-23(rejecting argument that TELRIC is unreasonable because it "calculates forward-looking cost by reference to a hypothetical, most efficient element at existing wire centers, not the actual network element being provided" and that "some degree of long-run inefficiency ought to be preserved through lease rates, in order to give an entrant a more efficient alternative to leasing").

Moreover, as the Supreme Court observed in *Verizon*, there is no basis for the argument that ILECs "will be stuck . . . with sunk costs in less efficient plant and equipment"[16] due to the introduction of "ever cheaper, more efficient technologies"[17] because, among other things, "TELRIC rates leave plenty of room for differences in the appropriate depreciation rates and risk-adjusted capital costs depending on the nature and technology of the specific element to be priced."[18]

TELRIC-based pricing provides appropriate compensation that encourages economic efficiency and that values ILEC investments in the same manner as they would be valued in a fully competitive market. Competition may change the ILECs' perspective on what investment strategy is profitable. In a competitive market, new investment by the ILEC may be necessary to produce more and higher quality service, while in a monopoly environment such decisions may have been frustrated because of their potential to reduce the profitability of the ILEC's past investments. The investment decisions of all rational carriers are governed by the perspective that the carrier will install further facilities or "units of capital" so long as the expected revenues from these investments exceed their costs (including associated risks), which is exactly the perspective that carriers face in a competitive market.

Importantly, the TELRIC model makes no assumptions about whether the market is actually competitive or not, because the level of competition in the marketplace does not affect the price calculation. Rather, TELRIC is designed to replicate competitive conditions regardless whether those competitive conditions otherwise exist at this time. As such, there is no need to

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16 *Id.* at 518.

17 *Id.*

18 *Id.* at 521.

adjust TELRIC or reexamine its appropriateness in light of an increase in competition in the relevant telecommunications market. Hence, the NPRM is flawed to the extent it is based on the assumption that the development of competition can affect whether TELRIC continues to be the appropriate UNE pricing mechanism.

In sum, the TELRIC-pricing methodology by definition sends the correct investment signals to the telecommunications industry and allows the ILECs to recover their full economic costs, including the risk-adjusted competitive rates of return on capital and forward-looking depreciation with lives that reflect both technological and economic obsolescence. Thus, when state regulatory authorities apply the TELRIC rules correctly, the resulting TELRIC-based rates are fully compensatory and send the correct pricing signals to all carriers. Accordingly, there is no basis for the ILECs' contention that fundamental flaws in the TELRIC-pricing methodology result in rates that are "too low" or that provide distorted investment signals to ILECs and CLECs alike. If a particular rate is too low, the appropriate response is to pursue means for ensuring that the states apply the TELRIC rules correctly, not to dispense with the TELRIC pricing methodology entirely.[19]

C. Drastic Changes to the TELRIC Pricing Methodology Could Inhibit, Or Even Halt, the Development of Competition

One unintended effect of departing from TELRIC now would be the chilling, or even freezing, of the development of competition. Specifically, drastic changes to the pricing

[19] The FCC should be careful to judge whether the states are applying the TELRIC standards appropriately based on how frequently, or loudly, the ILECs complain about the result. TELRIC rates should permit entry and competition, and the ILECs have no reason to facilitate entry and competition into their franchise monopolies. Consequently, the ILECs will always complain that TELRIC rates are too low as long as they facilitate any competitive activity.

methodology would tend to discourage entry by competitive carriers. Indeed, even modest changes could discourage efficient entry by increasing uncertainty about the prices that competitive carriers will have to pay for UNEs, particularly in light of the years of litigation that undoubtedly would follow an FCC decision to amend the TELRIC standard in any significant manner so soon after it has been affirmed by the Supreme Court.[20]

Regulatory certainty is crucial to fostering the competition envisioned by the 1996 Act. As the FCC has recognized, regulatory certainty is necessary to ensure that new entrants and fledgling competitors can design networks, attract investment capital, and have sufficient time to attempt to implement their business plans."[21] It is the constant wave of uncertainty surrounding the Commission's unbundling regime rather than TELRIC that discourages investment. These are the root causes for any lack of "clear signals" for investment that the Commission may perceive.[22] As the CLECs have already experienced, investors are not willing to fund a company whose right to exist is unsettled and constantly under siege. Therefore, CompTel and the PACE Coalition respectfully suggest that the FCC should focus on minor adjustments to the TELRIC standard to account for the TRO rather than on major changes or departures from the core economic principles upon which the TELRIC standard is based.

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20 *See Verizon Communications, Inc. v. FCC*, 535 U.S. 467 (2002).

21 *UNE Remand Order*, 15 FCC Rcd. at 3766, ¶150.

22 NPRM, ¶38.

III THE FCC SHOULD ENSURE THAT REQUESTING CARRIERS ARE NOT FORCED TO PAY THE COST OF FACILITIES OR CAPACITY TO WHICH THEY HAVE NO ACCESS

There is no evidence before the FCC or any of the states to suggest that the FCC should move away from TELRIC. TELRIC provides the ILEC with full cost recovery on a forward looking basis and the appropriate incentives to replace ILEC facilities with competitive facilities where it makes economic sense to do so.[23] As such, CompTel and the PACE Coalition urge the FCC to retain its existing TELRIC methodology with its long-run focus for establishing UNE prices.

Under no circumstances should the FCC modify TELRIC and depart from well-established pricing methodologies by developing an untested hybrid pricing mechanism that mixes aspects of embedded costs with economic costs or blends characteristics of short and long run pricing methodologies. These types of hybrid pricing mechanisms have no foundation in standard economic pricing concepts and could lead to unpredictable and ultimately anti-competitive results. They would also create great uncertainty both about specific aspects of the new approach and about how the states and the federal courts will interpret and apply the new approach.

The attached Declaration of Economist Joseph Gillan explains that the one circumstance under which the FCC might consider applying a short-run approach in place of TELRIC is where the TRO requires ILECs to provide requesting carriers with access to legacy network facilities but not to new network facilities that the ILEC can install to replace the legacy facilities. Under these conditions, the TRO imposes a short-run horizon on CLEC access: The ILEC will not

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[23] *See* Gillan Declaration, ¶5.

make any additional investments in its legacy network no matter what decisions CLECs make with respect to that network. As such, it might be appropriate to price access to the legacy network facilities based upon a short-run pricing methodology that will more accurately reflect the cost that the ILEC will incur with respect to the legacy network facilities (*e.g.*, the cost of maintenance).[24] However, if the FCC elects to apply a short-run pricing methodology under these circumstances, it must apply a short run model that is fully consistent with core economic principles, which most likely will result in prices that are lower than today's TELRIC-based prices.

Regardless whether the FCC retains TELRIC pricing (or applies a short-run economic pricing methodology for UNEs that ILECs can replace with network facilities which are not subject to unbundling), where the TRO requires ILECs to provide only "partial" access to a network element (*e.g.*, a 64kb channel on a broadband facility), the pricing for that particular network element should be allocated between the UNE and non-UNE applications in proportion to the relative bandwidth of each application. This cost-causative approach will prevent ILECs from requiring requesting carriers to fund network facilities to which they have no access and cannot use.

A. The 1996 Act Prohibits Reliance on Embedded Cost Methodologies Or Any Other Methodology That Relies In Any Part On Historical Cost

The FCC has the flexibility to implement the UNE pricing methodology that best achieves the goals of the 1996 Act, except that Section 252 of the 1996 Act[25] prohibits reliance

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[24] *See id.*, ¶6.

[25] 47 U.S.C. § 252(d)(1)(A) (providing in relevant part that rates for UNEs "shall be ... determined without reference to a rate-of-return or other rate-based proceeding.").

on historical or embedded costs when setting UNE rates.[26] As the Court explained, "[u]nder the local-compensation provisions of the Act, Congress called for ratemaking different from any historical practice, to achieve the entirely new objective of uprooting the monopolies that traditional rate-based methods had perpetuated."[27] The Court further explained that:

> [w]hile the Act is like its predecessor in tying the methodology to the objectives of "just and reasonable" and nondiscriminatory rates, 47 U.S.C. § 252(d)(1), it is radically unlike all previous statutes in providing the rates be set "without reference to a rate-of-return or other rate-based proceeding." § 252(d)(1)(A)(i). The Act thus appears to be an explicit disavowal of the familiar public-utility model of rate regulation (whether in its fair-value or cost-of-service incarnations) . . . in favor of novel ratesetting designed to give aspiring competitors every possible incentive to enter local retail telephone markets, short of confiscating the incumbent property.[28]

The Court also pointed out that "rate-of-return or other rate-based proceeding" have been identified with historical cost ever since *Hope Natural Gas* was decided.[29]

In addition to violating Section 252 of the Act, embedded cost methodologies or any other methodology that relies in any part on historical cost are inconsistent with the pro-competitive goals of the Act and the public interest. As the Court pointed out about embedded cost methodologies,

> the problem with a method that relies in any part on historical cost, the cost the incumbents say they actually incur in leasing network element, is that it will pass on to lessees the difference between most-efficient cost and embedded cost. . . . Any such cost difference is an inefficiency, whether caused by poor management resulting in higher operating costs or poor investment strategies

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26 *Verizon*, 535 U.S. at 500.

27 *Id.* at 488, citing H.R. Conf. Rep. No. 104-230, p. 113 (1996).

28 *Id.* at 489.

29 *Id.* at 500.

> that have inflated capital and depreciation. If leased elements were priced according to embedded costs, the incumbents could pass these inefficiencies to competitors in need of their wholesale elements, and to that extent defeat the competitive purpose of forcing efficient choices on all carriers wither incumbents or entrants. The upshot would be higher retail prices consumers would have to pay.[30]

For this reason, the Commission cannot implement any cost methodology that relies in any part on historical cost.

B. The UNE Pricing Mechanism Should Ensure that Prices Reflect the Cost Consequence of a Decision and Adhere to Core Economic Principles

Core economic principles establish that prices should reflect the cost consequence of a decision, because price is the primary mechanism by which resources are directed to their most productive use.[31] All decisions occur in the present but carry consequences for the future. The fundamental purpose of forward looking pricing, therefore, is to reflect to current users the future consequences of the decisions they make now. When a current user makes a decision today, the only costs that it can change are costs yet to be incurred. As such, a "forward looking" pricing perspective is not about setting UNE prices based on a prediction about future costs, but rather about setting UNE prices based on today's costs with the recognition that decisions made today can only affect costs on a going-forward basis.

In recognition that some decisions take longer to implement than others (*e.g.*, adjusting the output of an existing factory versus building a new factory), economics refers to different time horizons as the "short-run" and the "long-run."[32] In a short-run perspective, elements of

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30 *Id.* at 511-12.

31 *See* Gillan Declaration, ¶8.

32 *See id.*, ¶10.

production that cannot be changed within the relevant time horizon are held fixed (*e.g.*, the size of an existing factory) while elements that can be changed within the relevant time horizon vary (*e.g.*, the number of workers employed by the existing factory). By contrast, all elements are variable in a long-run perspective because the relevant time horizon is defined as being sufficiently long that all costs are variable.

The long-run perspective as reflected in the FCC's current TELRIC pricing methodology is critically useful to cost analysis in the telecommunications industry.[33] Only by adopting a long-run analysis is it possible to consider all network facilities, including those which cannot be adjusted quickly. Telecommunication facilities in general, and outside plant in particular, cannot be adjusted rapidly. In order to reasonably model all relevant costs, therefore, long-run costing approaches like the current TELRIC pricing methodology are appropriate.

In light of these considerations, there is widespread agreement among economists about the basic economic principles that the UNE pricing mechanism should reflect. First, costs should be forward-looking (rather than historical or embedded) because this is the perspective of competitive sellers and buyers, which base decisions on how they are likely to affect present and future costs and revenues. Second, the economically appropriate time frame over which to evaluate costs for pricing purposes is the long run rather than the short run, because competitive telecommunications markets move toward long-run costs. Moreover, one of the principal goals of the Act is to facilitate market entry, and new market entrants consider only long term costs because they have no embedded costs in the market. Third, costs must be based on least-cost production methods rather than actual potentially-inefficient production methods, because

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33 *See id.*, ¶11.

competitive markets punish carriers that fail to be efficient, and the prices are intended to foster the growth of competition. TELRIC incorporates these basic economic principles, and thus continues to be the appropriate UNE pricing mechanism.

C. The Modifications Proposed In The NPRM Inappropriately Mix Aspects of Embedded and Economic Costs or Blend Characteristics of Short- and Long-Run Pricing Methodologies

The FCC tentatively concludes in the NPRM that its "TELRIC rules should more closely account for the real-world attributes of the routing and topography of an incumbent's network in the development of forward-looking costs."[34] In order to achieve this goal, the FCC proposes two alternatives. First, the FCC asks for comment on whether it should "define the relevant network as one that that incorporates upgrades planned by the incumbent LEC over some objective time horizon (*e.g.*, three or five years), as documented, for example, in an incumbent LEC's actual engineering plans."[35] Second, the FCC asks for comment on "whether it is appropriate to assume that the cost of an existing element is the cost of that element if it were being replaced today. Under this approach, the cost to the incumbent LEC of using its existing facilities is the cost that would actually be incurred (including actual placement costs) to place new facilities in the same location."[36]

The FCC has not provided much detail about the alternatives, but the NPRM suggests that the cost of facilities that have not been treated as variable by the analysis would also be

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34 NPRM, ¶52.

35 *Id.*, ¶54.

36 *Id.*, ¶53.

included.[37] Specifically, the NPRM states that "[a]lthough this approach would take as given whatever existing facilities will remain in the network at the end of the designated period, it also should capture technological evolution within that period."[38] Under core economic principles, only the forward-looking costs of "whatever existing facilities [that] remain in the network" are relevant for pricing purposes.[39] However, in order for these facilities to have an associated forward-looking cost, they must be viewed as variable and optimized using the best available current technology. The Commission cannot simultaneously hold the facilities constant and include their cost in an economically sound way. By contrast, the Commission's existing TELRIC rules appropriately link the time horizon used for the economic analysis (*i.e.*, a long-run time period in which all facilities may be varied) with the corresponding requirement that the cost of network facilities should reflect the best available technology and current prices. As such, the approach discussed in the NPRM is fundamentally inconsistent with well-established economic principles, and thus should not be considered further.

In addition to containing theoretical flaws, the approach discussed in the NPRM has practical flaws. Specifically, the NPRM does not explain how the cost of "non-varying" plant would be calculated. In order to apply the current price of the best available technology, the plant would have to be engineered according to the design parameters of that technology.[40] The historic embedded cost of that plant would not be relevant to an economic model and, in any

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37 *See* Gillan Declaration, ¶13.

38 NPRM, ¶54.

39 *See* Gillan Declaration, ¶13.

40 *See id.*, ¶15.

event, may not be determinable in a verifiable way.[41] Consequently, in addition to being incorrect, the approach would likely require greater resources and be more controversial than the Commission's existing TELRIC rules, which are consistent with core economic principles.

The tentative conclusion that a forward-looking pricing methodology should more closely account for the real-world attributes of routing and topography of an ILEC's network[42] may also be contrary to the FCC's goals of ensuring that UNE prices (1) are "set in a manner that sends efficient entry and investment signals to all competitors," and (2) "provide incumbent LECs an opportunity to recover the forward-looking costs of providing UNEs."[43] It does make sense to include, to the best extent possible, real world attributes, but that does not necessarily mean that the ILECs' choices are the most reasonable or appropriate. The FCC should not modify well-established long-term cost concepts by requiring state commissions to consider any specific type of historical or sunk costs associated with an ILEC's existing network. Moreover, as the FCC found in the *Local Competition Order*, the approach contemplated in the tentative conclusion is essentially an embedded cost methodology, which is prohibited under Section 252 (d)(1) of the 1996 Act.[44]

Although the FCC cannot implement an embedded cost methodology or any other methodology that relies in any part on historical cost, consideration of the actual location of

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41 *See id.*

42 NPRM, ¶52.

43 *Id.*, ¶38.

44 As the Supreme Court found "there is even an argument that the Act itself forbids embedded-cost methods." *Verizon*, 535 U.S. at 1673 (explaining that "[i]f leased elements were priced according to embedded costs, the incumbents could pass these inefficiencies to competitors in need of their wholesale elements, and to that extent defeat the competitive purpose of forcing efficient choices on all carriers whether incumbents or entrants. The upshot would be higher retail prices consumers would have to pay.")

streets and rights-of-way can and should be accurately reflected in a TELRIC cost study, because these can affect forward-looking costs. The states typically have only adopted simplifying assumptions to minimize bias where actual rights-of-way are not known. However, a mere modeling of the actual network that the ILEC is currently operating in order to take into account historical or sunk costs cannot be considered to be a "long run" pricing methodology. The Commission should not attempt to modify the TELRIC pricing methodology by merely mandating consideration of the ILEC's existing network, because to do so would be to abandon the core principles of a long run pricing methodology.

For similar reasons, the FCC should not depart from the current TELRIC pricing methodology simply because "it is unlikely that any carrier, no matter how competitive the marketplace, would deploy new technology instantaneously and ubiquitously throughout its network."[45] Although the ILECs' networks contain a blend of elements and facilities, some of which are in the very beginning, the middle, and nearing the end of their useful life, this is a consequence of a series of decisions made in the short term that do not affect the ILECs' forward-looking costs. As such, the blend of elements and facilities that exist in the ILECs' existing network cannot be considered in a forward-looking pricing methodology. Over the long run, a carrier can install the exact quantity and quality of equipment that optimally fits the number of its customers and the types of services it offers. Therefore, it is irrelevant under a long-run pricing methodology whether a carrier can deploy new technology instantaneously and ubiquitously throughout its network.

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[45] NPRM, ¶68.

D. Improper Manipulation of the UNE Pricing Methodology In Order To Establish Higher UNE Prices Will Inhibit Competitive Entry

The NPRM appears to be based on the false assumption that increasing UNE rates will increase the incentives for investment by both the ILECs and competitive carriers. However, there is no evidence that the current TELRIC-based rates have chilled investment by the ILECs or competitive carriers, or that they have not allowed the ILECs to recover their costs. Further, the FCC has not provided any justification for changing the basis of its pricing policy from the rationale of promoting economically efficient investment to promoting investment for its own sake.

Prices that reflect higher historical or embedded costs merely shift the inefficiencies of the ILECs onto CLECs, which have no choice but to purchase inputs that are inherently flawed because they reflect the inefficiencies of the ILEC. Under these circumstances, the availability of UNEs would not foster the competition that is the goal of the 1996 Act. Instead, the UNE prices themselves would constitute a barrier to entry because the higher costs would be "real" and incremental to new entrants but illusory to the ILEC, which ironically will continue to base decisions on underlying economic costs. The creation of this regulatory entry barrier would suppress entry and pricing pressure on the ILECs' monopoly retail prices. To make matters worse, a historical or embedded pricing methodology would create incentives for the ILECs to adopt inefficient methods because the higher their costs, the less competition they will face.

The 1996 Act requires the FCC to eliminate entry barriers rather than create them. This statutory mandate includes requiring ILECs to share the "economies of scale,"[46] or, in the words

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[46] *UNE Remand Order*, 15 FCC Rcd. at 3703, ¶ 13.

of the Supreme Court, the "almost insurmountable competitive advantage"[47] they enjoy by virtue of their bottleneck control over local facilities. Since TELRIC rates would apply to elements that the Commission has concluded meet the impair standard, any increase in UNE rates will make it increasingly more difficult, if not impossible, for CLECs to enter and expand their presence. Although some CLECs might respond to higher UNE rates with an incremental reliance on competitive facilities at the margin, most CLECs will find it harder to enter a market or expand their market presence because the higher UNE rates will reduce CLEC profit margins, exacerbating the "almost insurmountable competitive advantage" that the ILECs enjoy.

The availability of UNEs facilitates entry and activity by all carriers, including the ILECs, and total industry investment expands as this competition results in lower prices, increased demand, and improved customer choice and service quality. Without meaningful access to UNEs, CLEC investment would be suppressed given the enormous advantages the ILECs enjoy, and ILEC investment would be suppressed because monopolists have no incentives to invest when the investment will merely cannibalize their existing monopoly services. Therefore, manipulating the TELRIC pricing mechanism in ways that are inconsistent with core economic principles in order to achieve artificial UNE prices would be fundamentally inconsistent with the 1996 Act because it would create entry barriers and inhibit competition rather than lower entry barriers and facilitate competition.

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47 *Verizon*, 535 U.S. at 490.

IV THE FCC SHOULD PROVIDE STATES WITH ADDITIONAL PRICING GUIDANCE IN LIGHT OF THE TRIENNIAL REVIEW ORDER

In the NPRM, the FCC asks for comment on the relationship between the numerous "significant changes to the regime for determining what elements must be unbundled by an incumbent LEC" that the agency made in the Triennial Review Order and "the Commission's UNE pricing rules."[48] Two of the ways in which the Triennial Review Order significantly changed the unbundling obligations of the ILECs are potentially inconsistent with a key assumption upon which the current TELRIC pricing methodology is based; *i.e.*, with respect to any network element that the FCC determines must be unbundled, the unbundling obligation applies to the entire network element.[49] First, the FCC imposed new limits on the access that requesting carriers have to certain unbundled network elements, which results in the "partial unbundling" of certain network elements.[50] The effect of "partial unbundling" is the creation of "shared facilities" that provide both unbundled and non-unbundled capacity. Second, the FCC created the potential for a legacy/emerging network dichotomy that limits the unbundling obligations of the ILEC to the legacy network, which can result in an "atrophying network" if the ILEC chooses to focus all new investment on the emerging network.[51]

In light of these significant changes, the FCC should provide states pricing guidance to allocate shared plant costs between UNE and non-UNE rates, and to reconcile any "forward looking" cost approach with network components where the ILEC does not intend to make any

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48 NPRM, ¶42.

49 *See* Gillan Declaration, ¶16.

50 The EELs restriction was an exception to the general policy that no use or capacity restrictions were permissible.

51 *See* Gillan Declaration, ¶17.

investment in the future. By providing guidance now, the FCC can reduce regulatory uncertainty and the opportunities for disputes between carriers over the effect of the TRO on the UNE pricing mechanisms when the various states initiate proceedings to update TELRIC-based UNE prices.

A. The FCC Should Provide Guidance on How To Allocate Costs and Set UNE Prices Under the Partial Unbundling Scenario

The FCC correctly notes in the NPRM that the "unbundling obligations set forth in the Triennial Review Order with respect to hybrid fiber/copper loops are limited," and asks what "adjustments, if any, should states make to recognize this more limited availability of UNE loops?"[52] One fundamental assumption underlying the TELRIC pricing standard is that the ILEC's network is unbundled and made available for use by competitors on a facility-by-facility basis. Under this assumption, the full TELRIC of a particular facility is used to establish tat facility's price. However, in light of the TRO, competitive carriers may have access to only a limited portion of a facility, in effect creating a "partial unbundling" scenario. Therefore, the Commission should provide guidance to the states on how to allocate the cost of a facility that is only partially unbundled.

In order to account for the "partial unbundling scenario, the Commission should adjust the pricing rules to ensure that the TELRIC of the facility is fairly apportioned between its UNE and non-UNE capacity. On balance, an appropriate allocation would be that the UNE-capacity (*e.g.*, a 64kb channel on a hybrid loop) should receive no more than a relative – by bandwidth –

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52 NPRM, ¶43.

assignment of cost.[53] Allocating TELRIC by bandwidth is appropriate because the primary purpose of the ILEC's broadband investment is to enable the ILEC, and the ILEC only, to offer broadband services. As such, there is no justification for assigning to the residual UNE capacity any greater than a proportional allocation of the cost.

B. The FCC Should Provide Guidance on How To Set UNE Prices Under the Atrophying Network Scenario

The FCC observes in the NPRM that its "new UNE loop rules limit the availability of fiber loops," and asks what "adjustments should be made so that requesting carriers are not charged for operating costs, such as maintenance, associated with deployment of fiber networks to which they have limited access?"[54] The decision to limit unbundling of next-generation fiber-based networks represents the Commission's attempt to encourage ILECs to invest in these new networks. However, this limitation complicates determining the appropriate economic price for facilities that the ILEC is strategically abandoning for non-economic (*i.e.*, regulatory) purposes.[55]

An important function of an economically efficient price is to signal to potential purchasers the value of the resources that would be directed into the production of the service or facility as a consequence of its decision.[56] Typically, this would mean that the price of a particular network element should reflect, at any point in time, the cost to reproduce the facility using the best available technology at the time.[57] However, in light of the FCC's broadband

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53 *See* Gillan Declaration, ¶18.

54 NPRM, ¶43.

55 *See* Gillan Declaration, ¶18.

56 *See id.*, ¶20.

57 *See id.*

rulings, the consequences in terms of resources of a CLEC's decision to purchase a UNE may no longer be linked to a subsequent ILEC investment decision: the ILEC will not make any additional investments in its legacy network no matter what decisions CLECs make with respect to that network. With no resource commitment at stake, it would not be appropriate to set UNE prices as though the use of legacy facilities by CLECs would eventually lead to replacement of those facilities by the ILEC. Therefore, to the extent that an ILEC chooses to atrophy the existing network, the appropriate price for legacy network elements should be based on the short-run costs that remain relevant (*i.e.*, any costs associated with operations and maintenance) associated with those elements.[58] However, to the extent that the ILEC voluntarily agrees to continue providing unbundled access to legacy network elements and continues to make investments in that network to accommodate CLEC demand, the ILEC should retain the opportunity to charge full TELRIC-based rates for those network elements.

V MODEST ADJUSTMENTS TO THE RATE STRUCTURE REQUIREMENTS FOR SWITCHING AND NON-RECURRING COSTS ARE NECESSARY

In the NPRM, the FCC seeks comment generally on "whether, and under what circumstances, changes are needed to our rate structure requirements?"[59] With respect to switching, the FCC asks whether it would be "appropriate to require that switching costs be recovered solely through flat-rated charges?"[60] CompTel and the PACE Coalition support the recovery of switching costs solely through flat-rated charges, and maintain that flat-rated pricing would comply with the statutory pricing standard under section 252(d)(1). Switching costs do

58 *See id.*, ¶22.

59 NPRM, ¶132.

60 *Id.*

not vary by minutes of use ("MOU"), and thus flat-rated pricing for switching would be appropriate. MOU pricing for switching leads to competitive inequality since competitors are forced to incur costs on a per-minute basis while the ILEC does not. This inequality is particularly problematic because the prevailing rate structure for local exchange service is to charge flat rates. As a result, the ILEC gains a significant advantage by imposing on its competitors an artificial cost structure (*i.e.*, a usage-based structure) that it avoids. Various states also support the pricing of switching on a flat-rate basis.[61]

The FCC also requests comments in the NPRM on "whether non-recurring costs should be recovered through NRCs or through recurring charges."[62] As a general matter, CompTel and the PACE Coalition support the recovery of most, if not all, non-recurring costs through recurring charges. CompTel and the PACE Coalition also support the FCC's proposal "to limit recovery through NRCs to those costs that exclusively benefit the competitive LEC ordering the UNE."[63] As the FCC correctly observes, this guideline "provides a mechanism by which an incumbent LEC can recover the cost of activities related to the initiation of service by competitive LECs, while at the same time reducing the barriers to entry for competitive LECs."[64]

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61 *See* Gillan/Crandall Testimony; UTAH; Ameritech Region; Matter of Petition of WorldCom, Inc. Pursuant to Section 252(e)(5) of the Communications Act for Preemption of the Jurisdiction of the Virginia State Corporation Commission Regarding Interconnection Disputes with Verizon Virginia Inc. and for Expedited Arbitration, Memorandum Opinion and Order, CC Docket Nos. 00-218 & 00-251, DA 03-2738 (rel. Aug. 29, 2003) (attached).

62 NPRM, ¶120.

63 *Id.*, ¶122.

64 *Id.*

This approach would provide incumbent LECs with full recovery of their forward-looking costs through recurring charges, and would simplify the calculation of NRCs by state commissions.[65]

VI CONCLUSION

For the foregoing reasons, the Commission should take the steps outlined above.

Respectfully submitted,

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[65] *See id.*, ¶123.

CERTIFICATE OF SERVICE

I, Beatriz Viera-Zaloom, do hereby certify that on this 16th day of December, 2003, a copy of the foregoing Comments of the CompTel/ASCENT Alliance and the PACE Coalition was served via electronic mail or by regular mail on the following:

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